

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

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Refer Reply To:

CC:CORP:6

PLR-144242-08

Date:

March 12, 2009

### Legend

Distributing =

Controlled =

LLC =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Business A =

Business B =

Business C =

Group C =

Group D =

State A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

a% =

b% =

c% =

d% =

e% =

f% =

g% =

h% =

i% =

j% =

\$k =

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Promissory Note =

Stock Purchase  
Agreement =

Adjusted Gross  
Margin =

Government  
Agency =

Agreement A =

Purchase Price =

Transitional  
Contracts  
Arrangement =

Dear \_\_\_\_\_ :

This letter responds to your October 10, 2008 letter requesting rulings on certain federal income tax consequences of a proposed transaction described below (the "Proposed Transaction"). Additional information was received in letters dated November 21, 2008, January 13, 2009, February 20, 2009, March 2, 2009, and March 11, 2009. The information provided in these letters is summarized below.

The rulings contained in this letter are based upon facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

In particular, this office has not reviewed any information pertaining to, and has made no determination regarding, whether the Proposed Transaction: (i) satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations, (ii) is used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (see § 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)), or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation (see § 355(e) and § 1.355-7).

### **Summary of Facts**

Distributing is a calendar year corporation that was incorporated under the laws of State A on Date 1, and since Date 2 has been taxed as a Subchapter S corporation. Distributing has no earnings and profits from its years as a C corporation. Distributing is engaged in Business A, Business B, and Business C. Distributing has one class of stock, voting common stock. Distributing's stock is owned a% by Shareholder 1, b% by Shareholder 2, c% by Shareholder 3, and d% by Shareholder 4.

The financial information submitted by Distributing indicates that Business C has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Shareholder 1 and Shareholder 4 disagree on a number of fundamental business

matters, and the conflict is having an adverse effect on the operations of Distributing. Accordingly, Distributing has determined that the separation, from the rest of Distributing, of a portion of the business assets of Business C, consisting of the Group C assets and related liabilities, will enhance the success of the business of Distributing and Controlled. The separation will enable each corporation to resolve the management and other problems that have arisen, and allow both Distributing and Controlled to achieve their potential by enabling the management and staff of each corporation to focus their efforts and energy on the respective requirements of their businesses without internal distractions and tensions. Distributing will retain the Group D assets of Business C.

### **Proposed Transaction**

For what are represented to be valid business purposes, Distributing has proposed the following transaction pursuant to Agreement A (the "Proposed Transaction"):

- (i) Distributing has transferred the Group C business assets and associated liabilities to its recently-formed and wholly-owned LLC, a disregarded entity.
- (ii) Distributing will contribute its LLC interest to a newly-formed and wholly-owned corporation, Controlled, in exchange for all the Controlled stock, with the result that Distributing will be treated as contributing the Group C business assets to Controlled, in exchange for all of the Controlled stock and the assumption by Controlled of the liabilities associated with the Group C business assets (the "Contribution").
- (iii) Distributing will distribute e% of Controlled stock to Shareholders 3 and 4 in exchange for all of their Distributing stock, and f% of Controlled stock to Shareholders 1 and 2 who will retain all of their Distributing stock (the "Distribution").
- (iv) Pursuant to the Stock Purchase Agreement, Shareholders 1 and 2 will sell their f% of Controlled stock to Shareholders 3 and 4 for a Promissory Note equal to Purchase Price consisting primarily of g% of Controlled's Adjusted Gross Margin each month for the period through Date 3.

The parties have structured this sale as an alternative to the use of a note to equalize the value of the Controlled stock with the value of the Distributing stock to be surrendered in the Distribution by Shareholders 3 and 4 because of concerns that a note of such amount between Controlled and Distributing would constitute an "affiliation" under a non-IRS Government Agency rule.

After the Proposed Transaction, Shareholders 1 and 2 will own all of Distributing. Shareholder 3 will own h% of Controlled, and Shareholder 4 will own the remaining i%

of Controlled. Controlled will operate as a holding company, with the LLC as its sole significant asset. Distributing will continue as an S corporation, and Controlled will become an S corporation effective from the date of the Distribution. Further, the LLC held by Controlled will issue to Shareholder 4 a j% profits interest in the LLC, which will cause the LLC's federal income tax status to change from a disregarded entity to a partnership.

In connection with the Proposed Transaction, Distributing and Controlled will enter into transitional agreements for a period not to extend beyond Date 4 following the Distribution. These transitional agreements are as follows: a space sublease (not to extend beyond Date 5), a corporate services agreement (not to extend beyond Date 4), a trademark license agreement (not to extend beyond Date 6), a note of only \$k issued by Distributing to Controlled having a maturity date of Date 7, and a Transitional Contracts Arrangement (not to extend beyond Date 8).

### **Representations**

The taxpayers have submitted the following representations in connection with the Proposed Transaction:

- (a) The fair market value of the Controlled stock received by each of Shareholders 3 and 4 will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the exchange.
- (b) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (c) The five years of financial information submitted on behalf of Distributing is representative of its present operations, and with regard to Distributing, there have been no substantial operational changes since Date 9, the date of the last financial statements submitted.
- (d) Following the transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of Business C conducted by Distributing prior to consummation of the transaction.
- (e) The Distribution is carried out for the following corporate business purposes: to solve shareholder disputes, enable a significant shareholder group to concentrate on a particular business, and to provide equity to a key employee. The Distribution is motivated, in whole or substantial part, by one or more of these corporate business purposes.

(f) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.

(g) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 1362(a) effective as of the first available date after the Distribution, and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

(h) Before and immediately after the Distribution, Distributing will have a single class of stock. Before and immediately after the Distribution, Controlled will have a single class of stock.

(i) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.

(j) The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

(k) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

(l) Payments made in connection with all continuing transactions between Distributing and Controlled (or any entity controlled directly or indirectly by Controlled) will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(m) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

(n) Even after taking into account Shareholder 4's post-Distribution acquisition of a j% profits interest in the LLC, the Distribution is not part of a plan or series of related transactions (within the meaning of § 1.355-7) pursuant to which one or more persons will acquire, directly or indirectly, stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).

(o) Shareholders 3 and 4 are the sole obligors for any liability created under the Stock Purchase Agreement or the Promissory Note.

(p) After the Distribution, other than certain contractual rights set forth in the transaction documents, which include the note of \$k, the only significant asset of Controlled will be its LLC membership interest.

(q) Neither Distributing nor Controlled will have any positive earnings and profits from C corporation years at the time of the Distribution.

(r) Distributing, Controlled, and each of their respective shareholders will pay their own expenses incurred in connection with the Proposed Transaction.

(s) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(t) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(u) No intercorporate debt will exist between Controlled (or any entity controlled directly or indirectly by Controlled) and Distributing at the time of, or after, the distribution of the Controlled stock, except for the \$k promissory note and intercompany loans or obligations that have arisen, or will arise, between the parties under the transitional agreements or in the ordinary course of business.

(v) Immediately after the transaction (as defined in § 355(g)(4)), either (i) no person will hold a 50-percent or greater interest (within the meaning of § 355(g)(3)) in Distributing or Controlled, (ii) if any person holds a 50-percent or greater interest (within the meaning of § 355(g)(3)) in any disqualified investment corporation (within the meaning of § 355(g)(2)), such person will have held such interest in such corporation immediately before the transaction, or (iii) neither Distributing nor Controlled will be a disqualified investment corporation (within the meaning of § 355(g)(2)).

(w) The total fair market value of the assets transferred from Distributing to Controlled will exceed the sum of (i) the amount of any liabilities assumed (within the meaning of § 357(d)) by Controlled, (ii) the amount of any liabilities owed to Controlled by Distributing that are discharged or extinguished, and (iii) the amount of cash and the fair market value of any other property (other than stock and securities permitted to be received under § 361(a) without the recognition of gain) received by Distributing in the

Contribution. The fair market value of the assets of Controlled will exceed the amount of its liabilities immediately after the Contribution.

(x) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of: (i) the total liabilities assumed (as determined under § 357(d)) by Controlled and (ii) the total amount of money and other property (within the meaning of § 361(b)) received by Distributing and transferred by it to its creditors and in connection with the plan of reorganization.

(y) The indebtedness, if any, owed by Controlled (or any entity controlled directly or indirectly by Controlled) to Distributing after the Distribution will not constitute stock or securities.

### **Rulings**

Based solely on the information submitted and the representations made, we rule as follows:

(1) The Contribution, followed by the Distribution, will qualify as a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled each will be “a party to a reorganization” within the meaning of § 368(b).

(2) Under §§ 361(a) and 357(a), Distributing will recognize no gain or loss on the Contribution.

(3) Under § 1032(a), Controlled will recognize no gain or loss on the Contribution.

(4) Under § 362(b), the basis of each asset received by Controlled from Distributing in the Contribution will be the same as the basis of that asset in the hands of Distributing immediately prior to the Contribution.

(5) Under § 1223(2), the holding period of each asset received by Controlled from Distributing in the Contribution will include the period during which Distributing held the asset.

(6) Under § 361(c)(1), Distributing will recognize no gain or loss on the Distribution.

(7) Under § 355(a)(1), the shareholders will recognize no gain or loss (and no amount otherwise will be included in their income) on the Distribution. See Rev. Rul. 98-27, 1998-1 C.B. 1159 (June 1, 1998) (“the Service will not apply *Court Holding* (or any formulation of the step transaction doctrine) to determine whether the distributed

corporation was a controlled corporation immediately before the distribution under section 355(a) solely because of any postdistribution acquisition or restructuring of the distributed corporation”).

(8) Under § 358(a)(1), the aggregate basis of the Controlled common stock received by each of Shareholders 3 and 4 in the Distribution will be, respectively, the same as the aggregate basis of the Distributing stock surrendered by each of them in the Distribution.

(9) Under § 1223(1), the holding period of the shares of the common stock of Controlled received by Shareholders 3 and 4 will include the period during which they held the Distributing stock surrendered in the Distribution, provided that each of Shareholders 3 and 4 held the Distributing common stock as a capital asset on the Distribution date.

(10) Distributing’s momentary ownership of the stock of Controlled, as part of the reorganization under § 368(a)(1)(D), will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B). If Controlled otherwise meets the requirements of a small business corporation under § 1361, Controlled will be eligible to elect to be a subchapter S corporation under § 1362(a) for its first taxable year.

### **Caveats**

No opinion is expressed about the tax treatment of the Proposed Transaction under other provisions of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the Proposed Transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding: (i) whether the Distribution satisfies the business purpose requirement of § 1.355-2(b); (ii) whether the Proposed Transaction is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both (see § 355(a)(1)(B) and § 1.355-2(d)); (iii) whether the Proposed Transaction is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in Distributing or Controlled (see § 355(e) and § 1.355-7). In addition, no opinion is expressed concerning the application of § 1374 to either Distributing or Controlled.

### **Procedural Matters**

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of this letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Mary E. Goode

Mary E. Goode

Senior Counsel, Branch 6

Office of Associate Chief Counsel (Corporate)